Martin Wolf: The dangers of the dollar's decline

By Martin Wolf

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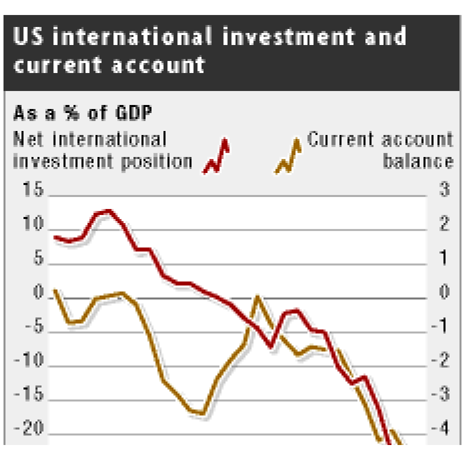
The dollar is falling. That is no surprise. The surprise is only how it is falling. Current account deficits and deflationary pressure are being shifted from the US towards other high-income countries. Among the most endangered is an already feeble eurozone.

Since the beginning of 2002, the Federal Reserve's broad trade-weighted index has fallen by about 12 per cent (see chart). As far as John Snow, the US Treasury secretary, is concerned, the decline has been "orderly". But what looks orderly to the US looks less so elsewhere.

Since the end of January 2002, the dollar has lost 31 per cent of its value against the Australian dollar, 30 per cent against the euro, 19 per cent against the yen and sterling and 18 per cent against the Canadian dollar. Yet against the most important of emerging market currencies, China's renminbi, the dollar has moved not at all. The Hong Kong dollar and Malaysian ringgit are also fixed. But even the Indian rupee, Korean won, Taiwanese and Singaporean dollars and Russian rouble have barely moved.

What is going on? "Intervention" is the answer. The world has returned to the Bretton Woods era, which ended in 1971, with the move to generalised floating. But it has done so only partially. Peter Garber of Deutsche Bank has put forward an elegant account of the new global monetary system at a forum organised by the International Monetary Fund.*

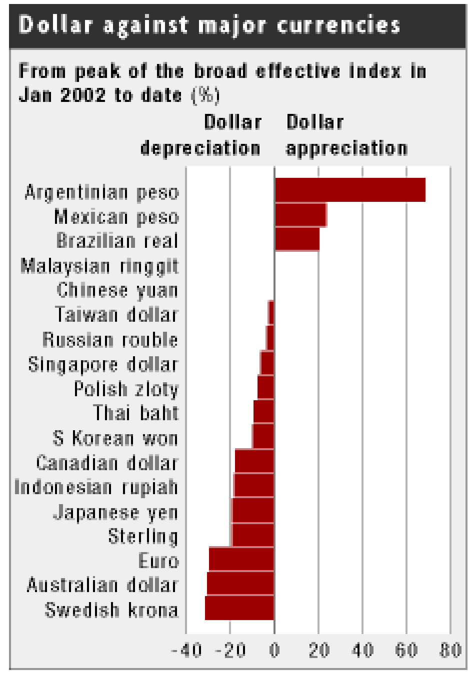
In the old Bretton Woods era, there were just two groups of countries: the US and the rest. The US, as the core country, adjusted to the policies of everybody else until, in 1971, it ceased abruptly to do so. Today, however, the world economy is divided into three parts: the US is the first; in Mr Garber's terminology, the "capital-account zone" is the second; and "the trade account zone" is the third. Countries in the capital-account zone target domestic monetary stability, while letting private capital flows set exchange rates. Countries in the trade-account zone fix exchange rates, while trying to sterilise the domestic monetary consequences.



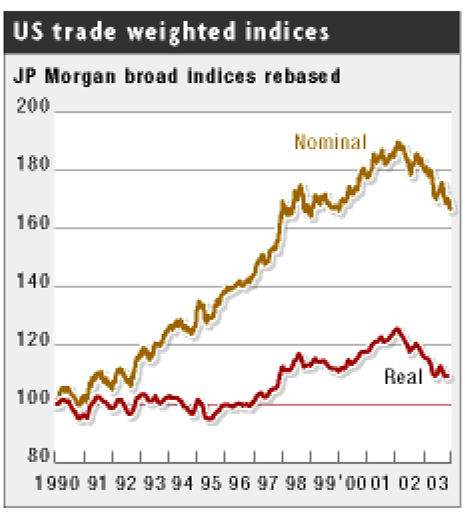
The objective of countries in the trade-account zone is growth. In Mr Garber's words: "The fundamental global imbalance is not in the exchange rate. The fundamental global imbalance is the enormous excess supply of labour in Asia now waiting to enter the modern global economy. The exchange rate is only the valve that controls that rate of entry." In order to maximise growth, Asian mercantilists lend the US the money with which to purchase their surging exports. When they demand repayment, the US will devalue and so partially default. The Asian strategy is to grow by giving.

Consider the implications of this tripartite division of the world economy. The US has a growing current account deficit, which has now reached 5 per cent of gross domestic product. As these deficits have piled up, the country has become a huge net debtor. At the end of last year, net liabilities were 25 per cent of GDP (see chart). The structure of the external sector, together with the political imperative of full employment, or what economists call "internal balance", is driving these deficits. At recent dollar exchange rates, internal balance has been possible only in combination with a huge external imbalance.

The growing external deficit appears to be structural: since 1990, US exports of goods and services have been growing at 5.7 per cent a year, in constant prices, while imports have been growing at 8.8 per cent. To avoid a continuing deterioration, one alternative is for the US to grow more slowly than the rest of the world. But Mark Cliffe of ING argues that it would need an 11 per cent fall in US GDP, relative to trend, to reduce the current account deficit to 2 per cent of GDP. It should go without saying that the US would not tolerate such a slump. There are two possible escapes from the recessionary trap: depreciation of the real exchange rate and faster growth in the rest of the world. But, according to Mr Cliffe, it would take a 36 per cent increase in the rest of the world's GDP, a 34 per cent decline in the trade-weighted dollar, or some mixture of the two, to reduce the current account deficit to 2 per cent of GDP.


Dollar against major currencies

So vast an increase in the rest of the world's relative GDP is infeasible. But depreciation is also at least partially blocked by the Asian mercantilists. In 2002 and the first half of 2003, foreign official purchases have financed a quarter of the US current account deficit. Between the beginning of 2002 and September 2003, Asian foreign currency reserves rose by $546bn. But the pressure on the US currency remains downward. It has been displaced, from the Asian mercantilists on to countries in the capital-account zone.


US trade weighted indices

Imagine, as a first possibility, that this continues, to give the US the overall depreciation suggested by Mr Cliffe. Then the dollar would be more than $1.60 to the euro and the yen possibly back at 80 to the dollar. This would be a recipe for deflation in the eurozone and even deeper deflation in Japan.

The second possibility is for members of the capital-account zone to join the Asian mercantilists in supporting the US currency. The monetary consequences would be expansionary. But though such an expansion would be welcome, it would be insufficient to reduce the US current account deficit. The result would be a faster global economic expansion, probably ending in worldwide overheating and a dollar collapse.

The third, and most benign, possibility would be for the Asians to decide not to play this game much longer: the reserve accumulation is too large and the US political backlash against rising deficits too powerful. These countries would then let their currencies rise, not dramatically but by a good margin against the US dollar.

That leaves a final possibility: the Nixon shock repeated. As the election comes closer, President George W. Bush announces an across-the-board import surcharge, to be lifted when all significant currencies appreciate against the dollar. The arrest of Saddam Hussein must make this less likely. But it is not inconceivable. At some point, the new Bretton Woods game will end. The question is when. In the meantime, those in the capital account zone must realise that a currency tidal wave is being deflected in their direction.

** Capital Flow Cycles: Old and New Challenges, http://www.imf.org/external/newsa.htm*

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Sources for charts: BEA; Thomson Datastream